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Nos. 06-1457 and 06-1462

IN THE SUPREME COURT OF THE UNITED STATES

MORGAN STANLEY CAPITAL GROUP, INC., *Petitioner*,
v.
PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY WASHINGTON, *ET AL.*, *Respondents*.

CALPINE ENERGY SERVICES, L.P., ET AL., *Petitioners*,
v.
PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY WASHINGTON, *ET AL.*, *Respondents*.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

AMICUS CURIAE BRIEF OF THE STATE OF WASHINGTON IN SUPPORT OF RESPONDENT

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AMICUS STATE OF WASHINGTON'S STATEMENT OF INTEREST

This case is of vital interest to the State of Washington because virtually all Washington's electricity consumers suffered from unjust and unreasonable wholesale electric rates as a direct result of the Western Energy Crisis of 2000–2001 (Western Energy Crisis), and in direct contravention of the specific protections of the Federal Power Act of 1935 (FPA) (16 U.S.C. §§ 791a–828c).

While an electric utility may be among the first affected when interstate wholesale electric markets go awry, consumers ultimately bear the financial burden when the FPA is not enforced properly. Washington and its electricity consumers have a strong interest in assuring that the FPA is interpreted and enforced appropriately to protect them.

A major purpose of the FPA is to protect consumers against excessive prices. *Pennsylvania Water & Power Co. v. Fed. Power Comm'n*, 343 U.S. 414, 418 (1952). The Federal Energy Regulatory Commission (FERC) is the sole protector of consumers when it comes to interstate wholesale sales of electricity. Under *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953 (1986), states have very limited power to redress exorbitant wholesale electricity prices when setting a utility's retail electric rates: "Once FERC sets [an interstate wholesale rate for electricity], a State may not conclude in setting retail rates that the

FERC-approved wholesale rates are unreasonable." *Id.* at 966.[1] Therefore, Washington's Utilities and Transportation Commission (WUTC) must pass through to ratepayers of investor-owned utilities the cost of power FERC authorizes, with little or no ability to test the reasonableness of that cost. A municipal or other publicly-owned utility, such as Public Utility District No. 1 of Snohomish County (Snohomish), must do the same.[2]

FERC's role in protecting consumers is also crucial because electricity is an essential service, subject to public interest economic regulation. As such, electric utilities in Washington and elsewhere have a statutory obligation to serve consumers. *See* Wash. Rev. Code § 80.28.110.[3] Typically, utilities purchase wholesale electricity in order to help fulfill this statutory duty to meet their customers' demand for electricity. Consequently, the contracts here are not discretionary; they are necessary purchases

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[1] Because this holding is based on FERC's "exclusive jurisdiction over the rates to be charged [the seller's] interstate wholesale customers" (*Nantahala Power*, 476 U.S. at 966), it appears the same restriction on State rate-making treatment of wholesale power costs in *Nantahala Power* would apply under FERC's more recent competition-based regulatory policy.

[2] Wash. Rev. Code § 54.24.080. In Washington, the WUTC regulates investor-owned electric utilities. Consumer-owned electric utilities such as Snohomish are exempt from WUTC regulation. *E.g.*, Wash. Rev. Code § 54.16.040.

[3] "Every . . . electrical company . . . engaged in the sale and distribution of . . . electricity . . . shall, upon reasonable notice, furnish to all persons and corporations who may apply therefore and be reasonably entitled thereto . . . all available . . . electricity . . . as demanded . . . ."

required to fulfill each utility's statutory duty to serve its customers.

Finally, Washington has an interest that markets function properly so that consumers receive the benefits of competition. For Washington's investor-owned electric utilities in regulated retail intrastate electric markets, that interest is enforced by the WUTC. Wash. Rev. Code chs. 80.01, 80.04, 80.28.[4] If electric markets were unregulated, that interest would be advocated by the Washington Attorney General through the State's Consumer Protection Act, which includes antitrust enforcement. Wash. Rev. Code ch. 19.86.

However, because FERC is the exclusive regulator of interstate electric markets, the State has no such role. Therefore, Washington has an interest in assuring that FERC's reliance on competitive wholesale electric markets confers upon consumers the benefits of competition without sacrificing the FPA's promise of "just and reasonable" rates.

SUMMARY OF ARGUMENT

Washington supports the Ninth Circuit's conclusion that FERC erred in denying Snohomish an opportunity to challenge the justness and reasonableness of the rate set by contract between

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[4] The Washington Attorney General also has a statutory role as "Public Counsel" to represent ratepayers in utility rate proceedings before the WUTC. Wash. Rev. Code § 80.01.100 ("It shall be the duty of the attorney general to represent and appear for the people of the state of Washington and the [WUTC] in all actions and proceedings involving any question under this title . . . .").

Snohomish and Morgan Stanley Capital Group, Inc. (Morgan Stanley). Given the dysfunction of the long-term electricity market during the Western Energy Crisis, FERC misapplied the *Mobile-Sierra* doctrine, setting too high a burden on Snohomish's challenge to the contract rate under Section 206 of the FPA (16 U.S.C. § 824e(a)). We address five issues to show why the Court should remand the case to FERC for further proceedings to determine whether the contract rate was "just and reasonable."

First, we refute FERC's and various amici's contention that FERC's response during the Western Energy Crisis sufficiently supports a *Mobile-Sierra* presumption that long-term contracts entered during that time were at "just and reasonable" rates.

Second, we recount the history of the FPA to show that Congress intended FERC's predecessor, the Federal Power Commission (FPC), to review wholesale contracts in the same manner as filed tariffs, and to take an active role in regulating those contract rates to protect the ultimate consumers of electricity whose rates are substantially dependent on the wholesale rates. The FPC, in its contemporaneous implementation of the FPA, took an active role in regulating the rates in negotiated contracts. This refutes various amici's assertions that Congress enacted the FPA to implement a regulatory system based on privately negotiated contracts, with limited regulatory review of those contracts by the FPC and subsequently FERC.

Third, because of FERC's failure to correctly interpret and implement the FPA, it is not, as FERC contends, entitled to deference under

Chevron U.S.A., Inc. v. National Resources Defense Council, Inc., 467 U.S. 837 (1984).

Fourth, we set forth two reasons why FERC erred in applying the FPA's provisions as interpreted in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956) (*Mobile*), and *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) (*Sierra*):

> (1) FERC erred by interpreting *Mobile* and *Sierra* as mandating that, under FPA Sections 205 and 206, contract rates must be presumed just and reasonable even though the contract was entered into during a time of severe market dysfunction; and
>
> (2) Even if, under Section 206 of the FPA, the contract between Snohomish and Morgan Stanley should be presumed just and reasonable, FERC erred by not adequately considering evidence of the dysfunctional market, and other factors, to overcome that presumption.

Finally, we summarize why permitting review of the contracts in this case will not adversely affect long term energy markets.

ARGUMENT

I. The Western Energy Crisis Was A Dramatic Market Failure In Which FERC Failed To Timely Protect Consumers From Excessive Wholesale Electricity Prices

It is uncontested that, beginning in Summer 2000, manipulatior and dysfunction in California

wholesale electricity markets drove prices to unprecedented heights throughout the western United States. FERC argues that it implemented timely and effective reforms to make those markets more stable and less susceptible to price spikes. *E.g.*, FERC Br. at 9. Several amici concur. *E.g.*, PowerEx Corp. Br. at 20.

In fact, FERC took no significant action to meaningfully protect consumers for one year. When FERC finally intervened, it limited its actions to short-term "spot" markets, but refused to control prices in longer-term "forward" markets.

A. In The Western Energy Crisis, Exorbitant Electricity Prices In The Spot Market Resulted In Unjust And Unreasonable Prices In The Long-Term Market

The first hint of a looming crisis came to light in June 2000, when the day-ahead (spot) electricity price in California skyrocketed to $1099 per megawatt hour (MWh), compared to the pre-1996 average price of $74/MWh (*i.e.*, before California restructured its electric power industry). *See Pub. Util. Dist. No. 1 of Snohomish County v. FERC*, 471 F.3d 1053, 1068 (9th Cir. 2006).

Similarly, in the Pacific Northwest, where the historical average spot price was about $24/MWh, average spot prices soared to between $200/MWh and $500/MWh during the summer and fall of 2000, finally spiking at $3300/MWh in early December 2000. *Id.* at 1069.

These shocking price increases and market volatility devastated Western utilities that had no choice but to purchase power to meet their statutory obligation to serve customers. Indeed, Snohomish increased its retail rates by nearly sixty percent during the crisis. Its contract with Morgan Stanley, by itself, accounted for about one-sixth of that increase even though the contract provided Snohomish with only 3 percent of its power supply. Snohomish Br. at 18; JA 1279a.

It was not until November 1, 2000, that FERC realized that wholesale electricity markets in California were "seriously flawed" and resulted in "unjust and unreasonable rates for short-term energy." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 93 FERC ¶ 61,121, at 61,349 (Nov. 1, 2000), 2000 WL 1637060. Essentially, the market FERC was relying upon to discipline electricity prices was dysfunctional, subject to abuses of market power, and producing prices that were not just and reasonable under the FPA.

FERC also recognized that the crisis was not limited to California, nor was it limited to spot markets. Indeed, FERC eventually found that California's energy problems created a "dysfunctional marketplace both in California and the remainder of the West"[5] and there was a "critical interdependence

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[5] *See also* 93 FERC ¶ 61,121, at 61,353 ("Notably high prices were also experienced at trading hubs throughout the Western Interconnection.").

among the prices in the [California] ISO's organized spot markets, the prices in the bilateral spot markets in California and the rest of the West, and the prices in the forward markets."[6] JA 680a.

Nevertheless, FERC failed to act quickly to protect consumers from these dysfunctional markets and the unjust and unreasonable prices that resulted. FERC now relies upon *Mobile-Sierra* to conclude it is prevented from remedying the harm it failed to prevent.

B. FERC Failed To Control Both The Spot And The Long-Term Markets

Despite FERC's recognition of a serious problem, FERC delayed price mitigation in the spot markets and never mitigated prices in long term markets, even though it promised to monitor and correct problems in those long term markets.

Although FERC held on November 1, 2000, that Western energy markets were dysfunctional, it waited until April 2001 to implement price caps in California spot markets. *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 95 FERC ¶ 61,115 (Apr. 26, 2001), 2001 WL 469974. Not until June 19, 2001, did FERC implement a *spot* market

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[6] *See also* 93 FERC ¶ 61,121, at 61,367 ("These higher spot market prices in turn affect the prices in forward markets."), 61,358 ("[D]uring the summer of 2000 correlations between PX prices and Western market bilateral prices were quite strong.").

monitoring and price mitigation plan across the rest of the West. JA 672a, 682a 691a.

FERC never implemented a price mitigation plan for the long term market. Instead, FERC encouraged utilities to shift their electricity purchases from the spot to the long-term market. FERC eliminated the requirement that California investor-owned utilities buy from and sell into the CalPX spot market and "strongly urge[d]" those utilities to move their load to long-term contracts of two years or more. JA 519a.

FERC recognized the potential for long-term prices to become unjust and unreasonable throughout the West as utilities followed FERC's urgings to shift their purchases from short-term to long-term markets. JA 521a–22a. Thus, FERC promised it would be "vigilant in monitoring the possible exercise of market power" in the forward market. JA 520a. To buttress this promise, FERC encouraged utilities to file a Section 206 complaint to address concerns about unjust and unreasonable contracts:

> "If DWR (or any other party) believes that any of its contracts are unjust and unreasonable, it may file a complaint under FPA section 206 to seek modification of such contracts." *San Diego Gas & Elec. Co. v. Sellers of Energy & Ancillary Servs.*, 96 FERC ¶ 61,120, at 61,515 n.59 (July 25, 2001), 2001 WL 1704964.

FERC also established a price of $74/MWh as an "advisory benchmark to assess potential complaints regarding long-term contracts." JA 523a–24a. It explained that "[t]his advisory benchmark should not be interpreted as establishing a price floor on forward contracts, which may justify a lower per MWh price."[7] JA 524a.

These commitments, however, proved hollow. FERC expressly rejected requests to extend price mitigation to forward contracts, asserting, contrary to its own findings, that "[p]arties have not provided justifications for extending the scope of our investigation or the mitigation to bilateral transactions other than spot markets." JA 710a. Further, FERC failed to adequately monitor the market-based rate authorizations it had issued to virtually every power marketer in the country. In those authorizations, FERC required each seller to file reports that would allow FERC to monitor for abuses of market power. However, as stated by the Ninth Circuit, FERC "abdicat[ed] its regulatory responsibility" to enforce those reporting requirements at the same time the "California energy market was subjected to artificial manipulation on a massive scale." *See California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1015, 1014 (9th Cir. 2004), *cert. denied sub nom. Coral Power v. California ex rel. Brown*, 127 S. Ct. 2972 (2007). FERC characterized this as merely a "technical compliance issue" (*id.* at 1014) when, in fact, the

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[7] At $105/MWh, the rate in the Snohomish/Morgan Stanley contract is significantly higher than FERC's benchmark.

power marketers' violations were fundamental and "rampant" (*id.* at 1014):

> "[B]ecause the reporting requirements were an integral part of a market-based tariff that could pass legal muster, FERC cannot dismiss the requirements as mere punctilio. If the ability to monitor the market, or gauge the 'just and reasonable' nature of the rates is eliminated, then effective federal regulation is removed altogether." *Lockyer*, 383 F.3d at 1015.

FERC's reliance upon market-based authorizations during the energy crisis was, itself, misplaced. FERC's own 2003 Staff Report[8] concluded that widespread market manipulation in gas and electricity markets contributed to the crisis and that this dysfunction in spot markets affected both forward prices and prices across the West.

In another case, FERC received evidence that abuse of market power by Enron affected markets in the Pacific Northwest. *Puget Sound Energy, Inc. v. Jurisdictional Sellers of Energy*, 101 FERC ¶ 61,304 (Dec. 19, 2002), 2002 WL 31969589. However, FERC refused to take that evidence into account in denying refunds for purchases in Pacific Northwest spot

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[8] FERC Staff, *Fact Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices*, Docket No. PA02-2-000, Final Report on Price Manipulation in Western Market (Mar. 2003). The entire Staff Report can be found in the Joint Appendix at pages 1sa to 404sa. The influence of spot prices on forward prices is discussed beginning on page 190sa.

markets. Its refusal was arbitrary and capricious, and subject to remand. *Port of Seattle v. FERC*, 499 F.3d 1016, 1035–36 (9th Cir. 2007).

FERC also waited until 2003 to revoke Enron's market-based rate authority, ultimately finding that Enron had engaged in market manipulation that resulted in unjust and unreasonable rates. *Enron Power Marketing, Inc.*, 103 FERC ¶ 61,343 (June 25, 2003), 2003 WL 21480248, *reh'g denied*, 106 FERC ¶ 61,024 (Jan. 22, 2004), 2004 WL 1483824. Ironically, just one day after FERC finally revoked Enron's market-based rate authority, FERC denied Snohomish's complaint seeking relief in this case.

II. In The FPA, Congress Intended The FPC (And Later FERC) To Review And Regulate The Rates Set By Contract Between Electricity Wholesalers And Their Customers

Though Congress created the FPC in 1920, authority to set rates resided with state commissions.[9] Then, in 1927, this Court held that state commissions lacked regulatory authority over wholesale sales of electricity in interstate commerce. *Pub. Utils. Comm'n of Rhode Island v. Attleboro Steam & Elec. Co.*, 273 U.S. 83 (1927). To fill this "*Attleboro* gap" in regulation and because of the

[9] *See* Federal Water Power Act, 41 Stat. 1063; *id.* § 19.

increasing importance of interstate sales of electricity, Congress enacted the FPA.[10]

In Section 213 of the FPA, Congress added a new Section 201 to the Federal Water Power Act establishing this new federal jurisdiction, but stated that "such Federal regulation, however, [is] to extend

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[10] The FPA was Title II of the Public Utility Act of 1935; Title I was the Public Utility Holding Company Act of 1935. 74th Cong., ch. 687, 49 Stat. 803. The House Committee on Interstate and Foreign Commerce summarized the purpose of the FPA:

> "The new parts are designed to meet the situation which has been created by the recent rapid growth of electric utilities along interstate lines. The percentage of electric energy generated in the United States that was transmitted across State lines increased from 10.7 in 1928 to 17.8 in 1933. The amount of energy transmitted in interstate commerce in 1933 was greater than all of the energy generated in the country in 1913. Under the decision of the Supreme Court of the United States in *Public Utilities Commission v. Attleboro Steam & E. Co.* (273 U.S. 83), the rates charged in interstate wholesale transaction may not be regulated by the States. Part II gives the Federal Power Commission jurisdiction to regulate these rates." H.R. Rep. No. 1318, 74th Cong., 1st Sess., at 7–8 (1935) (to accompany S. 2796).

See also Public Utility Holding Companies: Hearings on H.R. 5423 Before the House Comm. on Interstate and Foreign Commerce (House Hearings), 74th Cong., 1st Sess., at 498–99, 523 (1935) (statement of Dozier DeVane, Solicitor, Federal Power Comm'n); Public Utility Holding Company Act of 1935: Hearings on S. 1725 Before the Senate Comm. on Interstate Commerce (Senate Hearings), 74th Cong., 1st Sess., at 249–50 (1935) (statement of Mr. DeVane).

only to those matters which are not subject to regulation by the states." 49 Stat. 847 (16 U.S.C. § 824(a)). Indeed, the FPA was the federal government's first assertion of authority over rates charged by electric utilities, and it was intended to complement, not usurp, the authority of state commissions.[11] By filling this gap, Congress intended to protect consumers from excessive retail rates, recognizing that excessive wholesale rates would impact retail rates. *Pennsylvania Water & Power Co. v. Fed. Power Comm'n*, 343 U.S. 414, 418 (1952).[12]

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[11] *See* S. Rep. No. 621, 74th Cong., 1st Sess., at 17–18 (1935) (to accompany S. 2796); H.R. Rep. No. 1318, at 8 ("Probably, no bill in recent years has so recognized the responsibilities of State regulatory commissions as does title II of this bill."); Fifteenth Annual Report of the Federal Power Commission 2 (1935) ("In its procedural, no less than its substantive provisions, the Federal Power Act undertakes to assist and cooperate with the States in the regulation of electric utilities.").

[12] *See also* H.R. Rep. No. 1318, at 8. The FPC recognized this purpose. This relationship between wholesale rates and retail rates also was stated clearly in the legislative history of the Natural Gas Act, Pub. L. No. 75-556, 52 Stat. 821. *See* 81 Cong. Rec. 6723 (1937) (remarks of Rep. Wolverton) ("It can be readily seen that the price to be paid by the consumer depends largely upon the price the local distributing company or municipality has been required to pay to the outside producer. Therefore, if the consumer is to be given the benefit of purchasing gas at fair and reasonable rates there must be some regulation of the producing company engaged in the interstate transportation and sale of gas."); *see also* Eighteenth Annual Report of the Federal Power Commission 6, 11 (1938). The structure and purpose of the Natural Gas Act and the Federal Power Act are similar. *See Mobile*, 350 U.S. at 347; *Sierra*, 350 U.S. at 353. Indeed, initially Congress considered regulation of interstate sales of electricity and

Petitioners and various amici wrongly suggest that in the FPA Congress intended to authorize privately negotiated contracts as a substantial means by which rates for electricity, and conditions on those rates, were to be established. They imply a relaxed regulatory policy, bordering on a free market. For example, Morgan Stanley cites *Verizon Communications, Inc. v. Federal Communications Commission*, 535 U.S. 467, 478 (2002), for the proposition that the FPA departed from prior regulatory statutes by recognizing contracts.[13] Morgan Stanley Br. at 5.

However, this Court's comment in *Verizon Communications*, that the FPA's recognition of contracts was a departure from the model of the Interstate Commerce Act of 1887, 24 Stat. 379, merely reflects the reality that the staggering number of individual shipping arrangements in the interstate transportation industry made federal oversight of such contracts impossible. *Mobile*, 350 U.S. at 338–39.

Indeed, by recognizing contracts as a means of setting electric rates, Congress did not intend to immunize such contracts from regulatory review as part of some grander vision of a free market in wholesale energy sales. To the contrary, Congress enacted the FPA to bring such contracts under FPC

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natural gas in one bill. *See* H.R. 5423, 74th Cong. (1935). Accordingly, the respective legislative histories of the two acts inform each other. *See Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577 n.7 (1981).

[13] *See also* Coral Power Br. at 10;. PowerEx Corp. Br. at 11–14.

oversight, intending that the FPC scrutinize them to protect consumers whose rates are a function of these wholesale contracts.

Nor, as some amici suggest, did Congress intend the FPC to exercise a light touch regulating contracts. *E.g.*, Coral Power Br. at 10 ("Nothing in the text, structure, or purpose of the FPA suggests that FERC has the authority—much less the responsibility—to disturb traditional contract principles and decide for itself what rates are just and reasonable *as between the contracting parties.*"); Electric Power Supply Ass'n Br. at 4, 8. Amici's argument that Congress intended that the FPC take no active oversight of those contracts ignores the plain language and intent of the statutes, as well as the administrative construction placed on it by the FPC.

Section 205(c) of the FPA (16 U.S.C. § 824d(c)) requires each public utility to file with FERC all of its rate schedules (generally described as tariffs), as well as any individual contracts it enters into with utilities. Section 205(a) (16 U.S.C. § 824d(a)) requires that the rates, whether in tariffs or contracts, be "just and reasonable." Section 206 (16 U.S.C. § 824e) gives FERC authority to investigate rates, both those in a filed tariff and those in a contract. If the tariff or contract rates are not just and reasonable, FERC must set them to that level.

The Senate Report explains these requirements simply:

> "Subsection (a) [of Section 205] imposes upon public utilities the duty to charge just

> and reasonable rates *for every service* subject to the jurisdiction of the Commission. Charges that are not just and reasonable are declared to be unlawful.
>
> "....
>
> "Subsection (a) [of Section 206] authorizes the Commission, after a hearing held upon its own motion or upon complaint, to determine the just and reasonable rates and regulations and *contracts affecting such rates* in cases where it finds that the existing rates, regulations, and *contracts* are unjust, unreasonable, discriminatory, or preferential." S. Rep. No. 621, 74th Cong, 1st Sess., at 51 (emphasis added).

In addition to its plain language, the FPA's legislative history makes clear Congress's intent that the FPC actively oversee contracts. The House Committee on Interstate and Foreign Commerce considered whether there was a need for strict review of such contracts because they were made at "arms length," suggesting that therefore the rates would be reasonable.[14] The FPC's Solicitor refuted this suggestion in testimony:

> "I must take exception to the claim advanced here that unregulated wholesale contract between independent companies is

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[14] *See* House Hearings at 1340–41 ("We normally expect that the self-interest of the bargaining parties will result in establishing a reasonable rate between independent parties.") (written statement of Wendell Willkie, President of the Commonwealth & Southern Corporation).

not serious because these contracts are arrived at through the process of arm's length bargaining in which the self-interest of the bargaining parties is a sufficiently regulatory factor. The argument has as much force as if it was advanced in support of the right of the company to contract with its customers for service free of regulation. It assumes that the company can go out and purchase electricity as it could purchase coal, copper, or any other property or commodity used in it [sic] business that can be freely moved and delivered at any point. No matter how highly competitive electric sales may be in a particular situation, the field of competition is narrow and the possible sources of energy are few. A utility company is not free to buy in Illinois or on the Pacific coast energy that it might need in the New England States.

"Likewise, a company which has surplus power is frequently in no bargaining position to secure an advantageous price for that power. I do not mean to suggest that there should be any restriction on the interchange of power but what I do say is that *regulation is essential to protect the customers of both the purchaser and the seller.*" House Hearings at 2169 (remarks of Mr. DeVane) (emphasis added).

In addition to constitutional concerns about the authority of state regulatory commissions to disallow exorbitantly high wholesale costs in setting

retail rates,[15] the Committee also heard concerns about the legal and practical abilities of state commissions to audit out-of-state wholesale sellers and determine if their rates were reasonable.[16] Thus, one Committee member opined: "To that extent, therefore, is that not a good ground for the Federal Government having jurisdiction over that situation to say that no contract shall be entered into which will be binding before the law unless it is approved by the Federal Power Commission?" House Hearings at 1629 (remarks of Rep. Pettengill).

The final FPA as enacted continued to treat tariffs and contracts alike, and FPC's implementtation of the act shortly after enactment confirms that Congress intended the FPC to actively oversee wholesale contracts. The FPC described its efforts in its 1938 report:

> "Regulation of interstate contracts, involving both bulk supply of electric energy and intercompany relationships, is of basic importance for the State regulation of retail rates inasmuch as they constitute, in many instances, a hitherto inaccessible foundation

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[15] See the colloquy of Representative Pettengill and John E. Benton, the General Solicitor of the National Association of Railroad and Utilities Commissioners (now National Association of Regulatory Utility Commissioners), in House Hearings at page 1639. Later, this Court validated the view that state commissions could not disallow interstate contract rates. *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953 (1986).

[16] House Hearings at 1630 (statement of Mr. Benton); Senate Hearings at 757 (statement of Mr. Benton).

upon which local rates have been based. *Searching inquiries, therefore, have been directed to all contracts filed.*

". . . .

"*Each proposed change in a filed contract or rate is carefully reviewed by the [FPC] staff* and a complete report thereon made to the Commission. Approximately 200 changes were made during the past year. To facilitate these reports the Commission's rules of practice and procedure for filing of rates were modified. Each proposed change in rate must be accompanied by complete data supporting such change. These reports form the basis of Commission action for accepting or suspending proposed rate changes or initiating an investigation on its own motion." Eighteenth Annual Report of the Federal Power Commission 12 (1938) (emphasis added).[17]

Further, the FPC implemented the FPA with an eye to reducing the number of contracts, and moving the multitudes of individual contracts and conditions to a smaller number of generally applicable tariffs. As the FPC explained:

"The Commission's supervision of wholesale rates for electricity and natural gas transported or sold in interstate commerce is complicated by the fact that such rates are

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[17] *See also* Nineteenth Annual Report of the Federal Power Commission 10 (1939); Twentieth Annual Report of the Federal Power Commission 61, 70 (1940).

> embodied in individual contracts with the purchasing company rather than in rate schedules. A natural-gas company subject to the Commission's jurisdiction, sells to local distributing companies with each of which it has a contract. One company has filed over 300 such contracts.
>
> "*The Commission has recently initiated action toward the substitution of rate schedules for such contracts.* If such a change can be effectuated it will greatly lessen the Commission's work, facilitate comparisons of rates and permit a more ready interpretation and use of them by the public." Twentieth Annual Report of the Federal Power Commission 70 (1940) (emphasis added).

Because the FPC was substantially involved in the development of the FPA,[13] this administrative implementation of the act is relevant to its construction. *Zuber v. Allen*, 396 U.S. 168, 192 (1969). Contrary to what some amici suggest, this history confirms that the FPC assumed the role Congress intended: to actively oversee contracts in order to protect wholesale purchasers from unjust and unreasonable wholesale electric rates so that, in turn, retail customers would be protected from unnecessarily high retail rates.

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[18] *See* House Hearings at 57 (statement of Walter M.W. Splawn, Interstate Commerce Commission (formerly General Counsel to the Committee)); *id.* at 383 (statement of Frank R. McNinch, Chairman, Federal Power Commission); *id.* at 384–448 (testimony of Clyde L. Seavey, Commissioner, Federal Power Commission); *id.* at 449–576 (testimony of Mr. DeVane).

FERC's obligation to review wholesale contracts continues,[19] and it has not been disturbed by FERC's implementation of a market-based rate program. The FPA allows a challenge to an unjust or unreasonable rate contained in a contract just as it allows a challenge to an unjust or unreasonable rate contained in a tariff. *See also* California Pub. Utils. Comm'n Br. at 45–47.

III. FERC'S Interpretation Of The FPA Is Not Entitled To *Chevron* Deference

FERC failed to timely and adequately protect consumers during the Western Energy Crisis. Paradoxically, FERC publicly implored utilities to buy long term power, promising relief if there were problems, but then failed to act when problems did arise. *See supra* Part I.B.

Nevertheless, based on *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), FERC urges the Court to defer to its interpretation of the FPA that it need not consider market dysfunction in determining whether the *Mobile-Sierra* presumption of reasonableness applies. FERC Br. at 19–25. Given the history of the Western Energy Crisis and FERC's performance in administering the FPA to assure "just and reasonable rates," FERC is not entitled to *Chevron* deference.

Under *Chevron*'s two-step analysis, the first step is to determine whether Congress has "directly

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[19] Subsequent decisions of this Court confirm that Congress intended there to be strict review of contracts. *See* Snohomish Br. at 52–55.

spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter . . . ." *Chevron*, 467 U.S. at 842. The second step (if necessary) is to determine whether the agency's interpretation "represents a reasonable accommodation of conflicting policies," or if "it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned." *Chevron*, 467 U.S. at 845 (quoting *United States v. Shimer*, 367 U.S. 374, 382 (1961)).

In this case, the intent of Congress is clear. The purpose, history, and contemporaneous construction of the FPA all indicate that Congress did not intend to deprive consumers of any relief in a case such as this. Indeed, it defies the FPA's Section 206 clear language and common sense to suggest that there is no relief from undeniably unjust and unreasonable rates because they are embedded in a contract, when Congress specifically required that contract rates be subject to review for this very purpose. FERC's interpretation is simply not reasonable.

Strong policies underlie the Court's usual deference to federal executive agencies when agencies interpret their enabling statutes, and appropriately so. The Court should defer to a federal executive agency, particularly when that agency needs to "fill a gap" in its statutory scheme. *Chevron*, 467 U.S. at 844–46. However, here FERC not only failed to fill a gap, it *created* a gap by deciding it was essentially powerless to protect consumers from extreme prices for electricity in the long term market.

As the Ninth Circuit correctly observed, "[FERC's] approach to section 206 review simply cannot be squared with the statutory scheme." *Pub. Util. Dist. No. 1 of Snohomish County v. FERC*, 471 F.3d 1053, 1084 (9th Cir. 2006). Thus, the FERC orders cannot and do not reflect "a permissible construction of the statute." *Chevron*, 467 U.S. at 843. FERC's interpretation is not entitled to deference under *Chevron*.

IV. FERC Erred In Applying The *Mobile-Sierra* Doctrine To Limit Its Review Of The Contract Between Snohomish And Morgan Stanley

Mobile and *Sierra* considered whether the seller in a wholesale energy contract could unilaterally change the rate simply by filing a revised tariff for a different, albeit just and reasonable, rate. In each case, the Court found that, because the FPA provides for private contracts, it would be inconsistent with the Congressional purpose to allow the unilateral revision of contract rates. *Mobile* and *Sierra* did not establish new law. Rather, they applied a plain meaning interpretation of the FPA to wholesale gas and electricity transactions made under private contracts as opposed to transactions made under unilaterally filed tariffs.

However, this Court also recognized that, under the FPA, negotiated contracts were not immune from regulation. If the public interest so requires, FERC must reform the contracts. 16 U.S.C. §§ 824d–824e; *Mobile*, 350 U.S. 332.

FERC refused to reform the Snohomish-Morgan Stanley contract. In doing so, FERC misapplied *Mobile-Sierra* by treating the "public interest" as a separate, indeed superior, test from the statutory "just and reasonable" test for contract rates. FERC found that prices in the spot market were unjust and unreasonable and noted that its Staff Report found that such spot market prices "flowed through to forward power prices." However, anomalously, FERC held that even if those forward prices were unjust and unreasonable, they would not be contrary to the "public interest" because they were in a contract. *See* JA 1274a–75a. This reasoning could not be further from the letter and intent of the FPA. FERC further erred by failing to recognize that the *Mobile-Sierra* presumption should not apply if market conditions at the very formation of the contract were unjust and unreasonable. In any event, even if the *Mobile-Sierra* presumption does apply, FERC erred because there was substantial evidence to rebut that presumption.

A. The *Mobile-Sierra* Doctrine And Its "Public Interest" Standard Implement The Federal Power Act's "Just And Reasonable" Requirement For Contract Rates

In its decision, FERC drew a distinction between the FPA's "just and reasonable" standard and the "public interest" standard that FERC applies in reviewing contracts. JA 1275a–76a. This misstates and misapplies the applicable standard for review of a contract rate because there is no test

separate and apart from the "just and reasonable" standard. Under the FPA, *any* rate that is not just and reasonable is unlawful.[20] The Solicitor General, in its brief on behalf of FERC, and Morgan Stanley itself, agree that there is but one test, the "just and reasonable" test.[21]

This Court's discussion of the "public interest" in *Mobile* and *Sierra* simply recognizes that even when rates are negotiated in situations raising a presumption that the rates are just and reasonable, there are overriding considerations that can rebut that presumption. Those public interest considerations permeate the FPA and must inform FERC's implementation of the act.[22] However, the *Mobile-Sierra* doctrine cannot be read to sanction unjust and unreasonable rates as in the public interest because they are embedded in a contract.

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[20] Section 205(a) states: "All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission . . . shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful." 16 U.S.C. § 824d(a). Similar language appears in Section 206 (16 U.S.C. § 824e(a)).

[21] FERC Br. at 21; Morgan Stanley Br. at 7 n.4. This misconstruction of the proper standard by FERC is another reason why its interpretation of the FPA should not be given deference under *Chevron*.

[22] The FPA provides "the business of transmitting and selling electric energy for ultimate distribution to the public is affected with a public interest, and . . . Federal regulation of matters relating to generation [and] transmission of electric energy in interstate commerce and the sale of such energy at wholesale in interstate commerce is necessary in the public interest." 16 U.S.C. § 824(a).

B. FERC Erred In Interpreting *Mobile* And *Sierra* As Mandating That Rates Set By Contract Must Be Given A Presumption Of Reasonableness When The Contract Was Entered Into During A Time Of Severe Market Dysfunction

FERC's error in misapplying the statutory standard was compounded by its erroneous interpretation that *Mobile* and *Sierra* require that all negotiated contracts be given a "just and reasonable presumption," regardless of market conditions at the time of contract formation. JA 1275a–76a. Neither *Mobile-Sierra* nor the FPA requires such a presumption. Indeed, in the early years of implementing the FPA, the FPC apparently reviewed contracts in the same manner as it reviewed tariffs and, at least on occasion, modified those contracts. *See supra* Part II.

In *Mobile* and *Sierra*, the FPC was faced with sellers attempting to unilaterally modify contract rates. This Court held that they could not do that, even if the new rate was just and reasonable. Doing otherwise would render meaningless the Congressional intent to recognize contracts as a means of setting rates for wholesale electricity. *Mobile*, 350 U.S. at 344.[23] Because the FPA

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[23] The FPC interpreted *Mobile* and *Sierra* simply:

"[T]he Court affirmed decisions of the Court of Appeals for the Third and District of Columbia Circuits, respectively, to the effect that proposed rate increases filed pursuant to section 4 of the Natural Gas Act and section 205 of the Federal Power Act could not become

regulates sellers, not purchasers, this is an entirely appropriate holding, because sellers can protect their interests from the outset by simply declining to sell.

That is not the case for wholesale buyers such as Snohomish, which is buying electricity for resale to consumers. Such utilities exist to provide reliable power to consumers, who are the intended ultimate beneficiaries of the FPA's protections. When market conditions leave a buyer, such as Snohomish, unable to protect its interests or those of its retail customers and forced into contracts at unreasonable and unjust rates in order to meet its legal duty to serve its customers, then there can be no presumption that such a contract was just and reasonable. As FERC Commissioner Massey observed in his dissent:

> "The economic signals that formed the basis of the negotiations, and consequently the contract terms, were severely tainted. Buyers had their backs to the wall under these circumstances and essentially negotiated out of fears of yet higher prices or blackouts for their customers. Such conditions, spread over an area as large as the western United States, are truly extraordinary." JA 1316a.[24]

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effective unilaterally, i.e., without the concurrence of the customer companies or a determination by the Commission that the superseded contract rates are unreasonable." Thirty-sixth Annual Report of the Federal Power Commission 11 (1956).

[24] This argument is consistent with court of appeals cases upholding FERC's market-based rate system. In

The essential inquiry under the FPA is whether the rate is just and reasonable. FERC failed to undertake that inquiry. Therefore, the Court should remand this case for FERC to determine whether the contract rate was just and reasonable.[25]

Consumers Energy Co. v. FERC, 367 F.3d 915 (D.C. Cir. 2004), the court stated:

> "The Federal Power Act requires that public utilities charge 'just and reasonable' rates for the transmission or sale of electric energy. *Id.* § 824d(a). In competitive markets, 'FERC may rely upon market-based prices in lieu of cost-of-service regulation to assure a "just and reasonable" result.' *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993). '[T]he Commission approves applications to sell electric energy at market-based rates only if the seller and its affiliates do not have, or adequately have mitigated, market power in the generation and transmission of such energy, and cannot erect other barriers to entry by potential competitors.' *Louisiana Energy*, 141 F.3d at 365 (footnote omitted); *accord* Order No. 888 at 31,656." *Consumers Energy Co.*, 367 F.3d at 922–23 (alteration in original).

Obviously, FERC's market-based system is premised on a "competitive market."

[25] The Solicitor General, in its Brief in Opposition for the Federal Energy Regulatory Commission, at page 12, stated the holding of the Ninth Circuit:

> "The decisions below stand for the narrow proposition that, if there is a credible claim that severe market dysfunction has affected the formation of a market-based contract, the Commission must take that fact into account in determining whether the public-

C. Even If The Contract Between Snohomish And Morgan Stanley Should Be Afforded A Presumption Of Reasonableness, FERC Erred By Not Adequately Considering Evidence Of The Dysfunctional Market As Reasons To Overcome That Presumption

Even if FERC was entitled to presume that the Snohomish-Morgan Stanley contract was just and reasonable and then to apply a "public interest" analysis, given the evidence before it, FERC should still have reformed the contract. There are a number of "public interest" factors that support FERC's assertion of that regulatory power in this instance.

For example, as discussed above, FERC's own decisions issued around the time the Snohomish-Morgan Stanley contract was entered acknowledge that long term electricity rates were unjust and unreasonable due to the effects of market manipulation and market power. Snohomish Br. at 14–16; *see supra* Part I.

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interest standard of *Mobile-Sierra* applies to its review of that contract."

We believe this slightly misstates the holding of the Ninth Circuit, and it should not be the holding of this Court. FERC must do more than "take into account" market dysfunction in determining whether to apply the "public interest" standard in *Mobile-Sierra*. Where, as here, there is market dysfunction that affected the formation of a contract, the public interest discussion in *Mobile-Sierra* simply should not apply.

Moreover, the $105/MWh rate in that contract substantially exceeds FERC's own long-term "benchmark" rate of $74/MWh, which FERC set on December 15, 2000. FERC stated that it would use that benchmark to assess potential complaints against long-term contracts and it emphasized that the benchmark should not be considered a price "floor" on forward contracts. JA 524a.

In ascertaining whether these "public interest" factors justify the reformation of the Snohomish-Morgan Stanley contract, FERC should not construe the FPA to create an "insurmountable" presumption of justness or reasonableness.[26] This is especially important because, if the Court adopts an "insurmountable" presumption of legitimacy for contracts, rate-payers will have no meaningful protection from exorbitant rates set in dysfunctional markets.

The FPA provides for two means of reviewing rates to ensure they are just and reasonable. First, under Section 205, FERC may review a tariff before

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[26] The Court of Appeals for the District of Columbia has construed the "public interest" standard discussed in *Mobile* and *Sierra* as creating a standard that is "almost insurmountable" or "practically insurmountable," where a regulated utility seeks to unilaterally increase a contract rate. *See, e.g., Potomac Elec. Power Co. v. FERC*, 210 F.3d 403, 407 (D.C. Cir. 2000). This position is not a universal one, is not consistent with the analyses in *Mobile* or *Sierra* (*see, e.g., Northeast Utils. Serv. Co. v. FERC*, 55 F.3d 686 (1st Cir. 1995)), and should not be adopted by this Court.

it becomes effective. Second, under Section 206, FERC may review a rate, whether set by tariff or by contract, that had previously become effective. Both procedures allow interested market participants to review the rates and note their objections.

These traditional means of rate review are complicated by FERC's implementation of a market-based regulatory scheme. In that scheme, FERC permits public utilities to charge market-based rates rather than specific filed rates, after a general finding that the utility lacks market power, exempting the seller from specific regulation.[27] However, because market-based rates by definition are not specific to any given rate or contract, potential customers cannot use Section 205 to have FERC determine the real impact of specific rates. Therefore, the options for wholesale buyers, such as Snohomish, are limited to: challenging the seller's initial request for market-based authority under Section 205, moving FERC to revoke the seller's market-based rate authority, or seeking Section 206 review of a specific contract.

However, the first two of these options are illusory. A buyer would lack the incentive (if not standing) to challenge the initial grant of market-based authority because at that time it would not

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[27] *See Louisiana Energy & Power Auth. v. FERC*, 141 F.3d 364, 365 (D.C. Cir. 1998) ("[T]he Commission approves applications to sell electric energy at market-based rates only if the seller and its affiliates do not have, or adequately have mitigated, market power in the generation and transmission of such energy, and cannot erect other barriers to entry by potential competitors.") (footnote omitted); *see also* 61 Fed. Reg. 21540, 1996 WL 239663 (Order No. 888).

know whether it would ever purchase from a given seller. And, after a contract was entered into, it would be futile for a buyer to seek revocation of the seller's market-based rate authority because that would not affect the earlier contract.

The only viable option is the third one: a challenge to a specific contract under Section 206, which is precisely what Snohomish did here. However, by construing the FPA and *Mobile-Sierra* as mandating a high hurdle for that review, FERC skews the FPA to protect sellers rather than buyers, turning the act on its ear. In sum, because FERC's market-based regulatory scheme effectively eliminates FERC review of rates prior to their effectiveness, the FPA should not be construed to also make it virtually impossible to challenge them thereafter.

In *Mobile*, this Court stated that the FPA "affords a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other." *Mobile*, 350 U.S. at 344. The Court must reject the invitation to convert this "reasonable accommodation" into an "insurmountable" standard.[28]

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[28] The public interest factors articulated in *Mobile* and *Sierra* cannot simply be applied in this case. As noted by the Ninth Circuit and by Snohomish, this case involves buyers alleging contract rates are too high, not sellers alleging that they are too low as in *Mobile* and *Sierra*. *Pub. Util. Dist. No. 1 of Snohomish County v. FERC*, 471 F.3d 1053, 1088–89 (9th Cir. 2006). Snohomish Br. at 26–28. This distinction makes a difference. For example, Petitioners suggest that under *Sierra*, a local utility purchasing under a contract must show a risk of financial insolvency in order to invoke the "public interest" to

D. Allowing Snohomish To Challenge The Rates In The Morgan Stanley Contract Will Not Adversely Affect Long Term Stability In Energy Markets

Snohomish aptly refutes the unfounded speculation of the petitioners, FERC, and various amici[29] who say there will be damage to long-term energy markets if FERC scrutinizes these contracts under the statutory "just and reasonable" standard. Snohomish Br. at 55–59. For decades wholesale markets operated with tariffs and contracts, when both were subject to challenge and FERC (or FPC) review, and no such adverse impacts have materialized.

All FERC jurisdictional parties should understand that a contract entered into when the market is being manipulated or subject to market power cannot be sustained. The fact that such an unusual circumstance has now occurred, requiring FERC to exercise its statutory regulatory authority,

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reform a contract. *Sierra*, 350 U.S. at 355. Morgan Stanley Br. at 45–46; Calpine Br. at 43–44. However, rarely would a retail utility face that threat, because it can always pass the additional wholesale costs on to the ratepayers. The proper analogy to the *Sierra* example of a seller charging such low rates as to risk insolvency is not a buyer paying such high rates as to risk the same. It is the seller charging rates so high that they are outside the zone of reasonableness.

[29] Morgan Stanley Br. at 36–38; FERC Br. at 37; PowerEx Corp. Br. at 31–33; Int'l Swaps & Derivatives Ass'n, Inc. Br. at 1–20.

cannot support a claim that parties will shun future contract opportunities or that other adverse market effects will inevitably result. Even in the unlikely event that such adverse consequences should ensue, it is a result of a statute that Congress can change if it is deemed necessary.[30]

FERC itself offers the new regulatory tools provided under the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594, as a means to address future problems such as those that occurred in this case. FERC Br. at 31–32. We are also hopeful that these new tools, combined with the lessons learned from the Western Energy Crisis will enable FERC to regulate effectively the competitive scheme it established over a decade ago and prevent any future crisis. Significantly, however, while Congress provided FERC additional enforcement tools to better police the competitive markets, it left untouched the "just and reasonable" contract requirements of FPA Sections 205 and 206.

CONCLUSION

For the reasons set forth above, the Court should remand these proceedings to FERC with direction to determine whether the contract rate between Snohomish and Morgan Stanley is just and

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[30] FERC must share this view, because it opposed the granting of certiorari in this case, saying it could live with the Ninth Circuit's decision, in part because this case is unique: "[N]o other case addressed facts even remotely similar to those at issue here. The western energy crisis was the worst in the Nation's history. It arose from an unprecedented confluence of [events]." FERC Br. Opp'n at 22.

reasonable, in light of the market conditions surrounding the formation of that contract.

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